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Joint Policy Committee / Regional Planning Program

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To: Joint Policy Committee

From: Regional Planning Program Director

Subject: Smart-Growth Incentives for Developers and Investors

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The Joint Policy Committee (JPC) has requested information on smart-growth incentives. This memo is the third in a series intended to lay out a framework for understanding and organizing incentives and describing what is presently and potentially available to encourage smart growth. The first memo in the series inventoried incentives applicable to local government. The second described mechanisms that could assist neighborhoods in accepting infill development and associated community change. This third memo describes encouragements for developers and investors. Together, the three memos comprise a broad *menu* from which the JPC, its member agencies, and others may explore and choose various incentives to facilitate the smart-growth vision.

1. Developers, Investors and Smart Growth

Developers play a key role in the real estate business comparable to a producer in the movie business. They are the folks who bring all the various players, interests and factors together to make something happen. They option and acquire sites, work with local governments and neighborhoods to obtain development entitlements, arrange financing, hire architects, engineers and contractors, and market the product. Development is a difficult and risky business, and "smart" development can be more difficult and more risky than the alternative. It is hard enough in today's highly regulated, litigious and fiscally constrained climate to develop virgin land on the urban fringe. It is an order of magnitude more difficult to make development happen on an infill site or on recycled land within an existing community—particularly if it involves a change in density or use.

Good, experienced developers know that, while the difficulties are many, the rewards of "smart" development can also be substantial. But, that knowledge and confidence may not be shared by some investors, who look upon a riskier development project as one of many alternative uses for their money and may not have the patience it takes to work through the twists and turns of reuse or innovation. Incentives which act to reduce these frictions and uncertainties may attract more developers and investors to smart projects. Carefully targeted incentives can also establish positive examples and an environment of success that help additional players recognize the smart-growth opportunity.

2. Incentives to Developers and Investors

As with incentives for other actors in the development process, incentives to developers and investors can be arrayed along a continuum from intangible to tangible. Many of the intangible incentives appeal to the creative side of the development business; they help define the opportunity and manage the challenge. More tangible incentives may be required to help creative projects pencil out. They directly add revenue or reduce costs and can make the difference between profit or loss in a development *pro forma*.

Tangible incentives can be delivered by federal, state and local governments. Local governments can, as well, offer many intangible incentives. Regional agencies have few, if any, incentives, tangible or intangible, which they can deliver directly, but they can play an important role in identifying and brokering incentive packages.

This memo starts with some of the tangible financial incentives potentially available to encourage developers and investors to undertake smart growth. It then works its way through to some intangible enticements that can attract and facilitate development consistent with the regional vision.

2.1 Tax reductions

Although not as widely and systematically used in California as elsewhere, property tax abatements and other tax deals are well-established mechanisms used by many local governments across North America to attract development. In fact, some believe that local tax incentives have been a key factor underlying sprawl: municipalities on the suburban fringe are seen to have used tax deals to help lure away businesses from older, more fiscally challenged central cities and inner suburbs. This has been described as a zero-sum game resulting in the abandonment of accessible central sites and, worst yet, the abandonment of an inner-city labor force, which finds it difficult to get to or live near new dispersed suburban jobs.

Contrarians argue that tax incentives have little real impact on gross location decisions; that they are mostly windfall rewards for businesses that would have made similar location decisions in any event for more fundamental economic reasons unrelated to the tax break. At best, tax concessions influence marginal choices among competing suburbs.

Regardless of their arguable short-term effect, for metropolitan good or for bad, most informed observers agree that tax incentives are of questionable long-term effectiveness in securing economic development and jobs. Although they are big deals for the local governments that give them, tax breaks are frequently overwhelmed by other more global economic concerns for the corporations that receive them. There are no long-term guarantees, and it is easy to find vacated office parks and factories, symbolic of local-government tax bets gone wrong. On the other hand, there are also a lot of apparent success stories and a continuing perception that localities win or lose based on the concessions they offer. Therefore, tax competition continues to persist in spite of the protestations of many regional development experts.

While tax considerations have been used to help retain businesses in traditional central settings and occasionally to attract businesses to “smart” locations (particularly to buoy up the jobs side of a jobs/housing imbalance), their use in smart-growth situations has not been prominent. Other than the special case of tax increment financing (TIF), tax incentives are mentioned hardly at all in the smart-growth literature except as a negative influence.

Clearly it is hard to envision property-tax forgiveness playing much of a role at all in achieving the Bay Area’s principal smart-growth objective: compact housing development. Unlike some commercial and industrial development, housing provides few direct fiscal *quid pro quos* for local government to compensate for the foregone property tax revenue. And in the absence of binding regional constraints, tax abatements for commercial and industrial development would most likely just amplify the undesirable effects of fiscalized zoning.

At this time, there appear to be only two limited cases, beyond redressing intra- and inter-regional job imbalances, where tax abatements may be useful as smart-growth incentives. One is currently permitted by California law; the other would seem to require new legislation.

Currently permitted by the 1972 Mills Act are tax abatements for historic preservation. These abatements may be of assistance to adaptive reuse of historic structures in existing communities. New residential development in old commercial or industrial buildings is an effective form of infill which also retains historic character. The rehabilitation of historic retail districts may make the immediately surrounding area more attractive for more intense residential redevelopment, and the preservation of some historic housing stock—even at existing densities— may contribute to affordability objectives.

Another limited use of local tax incentives in association with smart growth may be the facilitation of mixed use in <u>new</u> development as well as in historic structures. A classic problem faced by nearly all large-scale mixed-use developments relates to the economics of providing retail and other commercial services before there is enough proximate residential market to support them. Yet the presence of those service uses in active operation can be very helpful in marketing the new residential units and in making the development work as a self-contained “village” as intended. Were they permitted, limited-period tax abatements to resident-serving commercial uses might assist mixed-use development economics during the critical start-up phase.

While local governments generally cannot afford to facilitate housing development through tax concessions, state and federal governments are in a very different position. In fact, income-tax credits are the principal means through which the federal and state governments subsidize the private provision of affordable housing. Typically developers sell dollar-for-dollar reductions in income-tax liability to investors and then apply the funds directly to the capital costs of affordable units.

A finite dollar amount of federal and state low-income housing tax credits are allocated in California by the California Tax Credit Allocation Committee (CTCAC). As part of a very complex, multi-objective scoring system within a complicated administrative process, CTCAC employs a few smart-growth criteria in awarding project points: in particular, location relative to transit and commercial services and situation within a revitalization area. The effective weight of these points relative to other objectives is difficult to assess. Because of low-income rental rate limitations, additional federal, state, and local subsidies, such as project-based Section 8 vouchers, may be required to make the economics of tax-credit housing work in high-cost urban areas. Another common federal tax subsidy for affordable housing occurs through the use of tax-exempt bonds.

While restricted federal and state tax credits and other tax subsidies have been used primarily to encourage the limited provision of affordable housing, it is conceivable that federal and state tax policy could also be directed to tip the balance in favor of other kinds of responsible “smart” development. Were there sufficient interest and will, a system of carefully targeted tax concessions (possibly effected through both income tax credits and state sales tax exemptions) could be justified by reductions in urban infrastructure and other public-service costs. Such a system would, however, run counter to current initiatives to simplify tax codes and their administration.

2.2 Tax Increment Financing

Tax increment financing (TIF) is a mechanism that local governments, through redevelopment agencies (RDAs), can use to encourage private development. By borrowing against future incremental tax revenue in a redevelopment area, RDAs can finance public infrastructure which otherwise might have to be paid by developer impact fees. Further, a RDA may use TIF to acquire property and to construct or rehabilitate buildings for private use, providing, in effect, a tax-financed subsidy to private investment.

California redevelopment law currently restricts the use of TIFs and other redevelopment powers to “blighted” areas. However, recently introduced legislation (SB 531) seeks to broaden the already somewhat elastic definition of “blight” to include the absence of high-density housing in transit-oriented development areas. Another bill (AB 1203), while currently lacking detail, proposes to use TIF to facilitate greyfield redevelopment without apparently going through the artifice of “blight” or invoking the full range of associated redevelopment powers.

TIF is an incentive mechanism which has been used in California since 1952. Its extensive use beyond a small set of narrowly defined areas involves some risk that the anticipated differential tax increments will not be forthcoming. However, as part of a carefully managed and monitored smart-growth strategy, TIF may be the single most important incentive tool currently available to motivate private investment. A cautious extension beyond genuinely blighted areas is certainly worthy of serious consideration.

2.3 Land Assembly and Land Write-downs

Another very significant tool available under California redevelopment law is the power of eminent domain. This allows redevelopment agencies to condemn individual privately owned private parcels, consolidate and replat them into larger development sites (potentially also incorporating vacated streets and other public land) and sell them to private interests for redevelopment. Local governments, through RDAs, can provide a substantial incentive and development subsidy by relieving private developers of the cost and hassle of assembly. They can also ensure through the condemnation process that all required parcels are acquired at fair market value and that there are no extortionary holdouts. Further land write downs, supported by tax increments, can increase the subsidy and the incentive. In addition to providing for TIFs, SB 531 would allow the use of eminent domain and related real estate subsidies in transit-oriented development areas.

One indirect means of reducing land costs for developers, involving only an opportunity cost for local governments, is to make the publicly acquired land available through long-term, prepaid lease rather than fee-simple purchase. A typical deal would provide land with a sixty to ninety-nine-year lease for a prepaid amount of two-thirds to three-quarters of the fee-simple purchase price, with the land reverting to the locality at the end of the lease. Leases may be renegotiated and extended before expiration to allow secondary purchasers (usually condominium owners) to continue to mortgage their properties.

The public assembly and planning of redevelopment areas may also permit the pooling of some development cost and the collectivization of some required uses, particularly parking. The developers in a redevelopment area may benefit from economies of scale produced by constructing one large shared parking structure, and total parking requirements may be reduced by planning for shared use, noting that different uses generate peak parking demands at different times of the day.

2.4 Fee reduction

Local governments levy two kinds of development fees: permit fees (for services like development approval and building inspection) and impact fees for required infrastructure and other services (of which CEQA mitigation fees may be a special case). Properly planned smart development may provide an opportunity to reduce both of these fees and thus provide some incentive for development to occur in “smart” areas. MTC funding for station area plans and State funding for specific plans, as proposed in SB 223 (Torlakson), provides an opportunity to consolidate some planning expenses upfront and achieve some economies of scale, thus potentially reducing the amount and cost of planning analysis required for individual projects. Directing development to infill areas with existing infrastructure and service capacity can obviate the need for some impact fees, particularly if a locality can resist goldplating its standards or inflating its requirements to placate community opposition.

2.5 Financing Assistance

Loans and loan guarantees at favorable rates are traditional ways through which governments have assisted socially beneficial projects. While not specifically targeted at smart projects, the Finance Authority for Non-Profit Corporations, an ABAG service, provides financing assistance to affordable housing suppliers. The ABAG Special Assessment Bond Roundup Program (SABR) offers an inexpensive way for local governments and developers to cooperate in setting up special assessment districts and issuing Mello-Roos Bonds.

2.6 Risk Management

Developers experience at least three kinds of risk in pursuing smart projects: the risk of a lengthy or unsuccessful approvals process, the risk of unanticipated high mitigation costs (particularly those associated with cleaning up contaminated brownfield sites), and the risk of construction defect litigation for higher-density, multi-family development. To the extent that governments can assist in lessening or managing these risks, they can reduce overall development costs and therefore encourage more development.

Exemption from CEQA requirements has been suggested as one mechanism for decreasing approvals risk—particularly for housing infill. SB 1925 (Sher), signed into law in 2002, provided CEQA exemptions for a small class of affordable housing and infill development, particularly in the City of Oakland. SB 832 (Perata, Lowenthal, and Torlakson), introduced to the current sitting of the Legislature, expands CEQA exemptions to in-fill projects of up to ten acres and 300 residential units, in cities of 200,000 or more in population. Four Bay Area cities—San Jose, San Francisco, Oakland, and Fremont—would qualify.

Cities and counties may also reduce approvals risk for individual developments by placing them in the context of well-developed plans that have been subjected to rigorous public review prior to individual project submission. Under current California planning and environmental law, master environmental impact reports (MEIRs) may be prepared in conjunction with specific plans. These MEIRs can reduce uncertainty and many requirements for individual EIRs. The specific plans also provide a clear, ascertainable statement of public policy which can reduce risks for both developer and community. SB 223 (Torlakson) proposes to provide a revolving loan program to finance the preparation of specific plans. MTC will be providing grants for specific plans for some proposed transit-station areas. The facilitation of specific plans and master EIRs is a key component of the legislative agenda approved by the JPC in September.

Both federal and state governments offer a variety of resources to deal with the risks of brownfield mitigation. These range from indemnity from certain types of liability, to hazard insurance, to remediation loans and grants. One big problem appears to be in assessing and accessing the resources available. This may be particularly difficult for developers of smaller parcels who may not have the professional resources required to guide them through the complicated brownfield redevelopment process. The City of Emeryville has been remarkably successful in organizing a risk-management approach to assessment and remediation and in assisting developers through the brownfield minefield in its community. Others may learn from this example. The California Center for Land Recycling provides a program of loans, grants and technical assistance to help small non-profits redevelop environmentally distressed properties.

The fear of expensive construction defect litigation and the cost of insuring against this litigation are argued to impede the construction of multi-family housing for the ownership market. The development industry has asked for legislation to limit what it regards as meritless and frivolous suits or at least legislation that substitutes a less expensive mediation process. Opponents have argued that housing purchasers require all effective legal remedies to deal with shoddy construction and that litigation would not be an issue if construction were of acceptable quality. Some also note that there is some equity benefit in the current practice of initially building multi-family units for the rental market and then converting to ownership when litigation is no longer possible. Regardless of the truth and the merits of various arguments and counter-arguments, to that extent that the threat of litigation is an excuse for underperformance, it needs to be dealt with—either with the improvements that the industry is seeking or with better information to identify and fix the real problem.

2.7 Regulation Concessions

Local governments may relax a number of development regulations in order to encourage particular types of development or development at specified locations. Subject to maintaining public safety, virtually anything in a zoning, subdivision, or building code is fair game, but the most common relaxations relate to density, use, height, setbacks and parking. These concessions generally increase the effective yield and hence the return on investment per unit of land.

Through recently amended legislation—SB 1818 (Hollingsworth, 2004)—the State of California requires local governments to provide a prescribed and applicant-selected package of density bonuses and other concessions to developers who include affordable housing units or childcare facilities in their projects or donate land which may be used for those purposes. Pending AB 986 (Torrico) proposes to increase the state-prescribed density bonus by five percent for mixed-use projects located within priority transit-oriented development areas designated by the JPC.

In other jurisdictions, non-mandatory density bonus programs have been fashioned by local governments themselves to encourage the private provision of social, cultural, recreational or aesthetic amenities in association with new development. These amenities are typically sought to make the community more complete and livable.

One area of regulation relaxation of special interest to smart growth, and to transit-oriented development in particular, concerns parking standards. As the provision of an on-site parking space can cost between fifteen to thirty thousand dollars, the reduction of parking requirements can save developers and ultimate unit purchasers a lot of money. There is also some suggestion that if you build it, they will come: that if excess parking spaces are provided, residents will choose to own more cars and use those cars in preference to transit. Therefore, the provision of less parking, in addition to resulting in cost and land-consumption efficiencies, is thought, to be more transit friendly. However, many developers point to the reluctance of investors to finance projects built with smaller than standard parking complements. Units without ample parking are perceived to be less marketable. MTC is about to undertake a study to gauge actual parking demand in transit-oriented districts and the effect of parking supply on transit usage.

Building code refinements can also act as smart-growth incentives. Codes which encourage the adaptive reuse of former industrial or commercial structures and which facilitate mixed-use can assist in-fill and the development of complete communities. With proper care, safety need not be compromised.

2.8 Processing efficiencies

At today's interest rates, holding costs are not as expensive as they once were. However, time continues to be money, and localities that reduce the processing time for permits and other approvals will be more attractive to developers and investors. Among the improvements which can reduce processing time, as well as introduce greater ascertainability and certainty into the process, are the following:

- One-stop-shopping, an increasingly common practice, wherein approving authorities are co-located for the convenience of the applicant;

- Published processing manuals and flow-charts to assist all concerned in understanding and navigating municipal processes;

- Project scoping and streaming, separating simple projects from complex projects and placing them in different queues to reduce wait time;

- Development facilitation, wherein a single local government staff member is assigned to assist the development applicant and shepherd that applicant's project through the government bureaucracy (usually only employed for complex projects);

- Concurrent processing, wherein the requirements of multiple departments or agencies are dealt with simultaneously, rather than sequentially;

- Approvals delegation, vesting limited multi-agency authority in single agencies or individuals, allowing them to process a class of applications on behalf of more than one department or agency;

- Process monitoring, targets and guarantees, setting objectives for moving different classes of applications through the system, initiating interventions for applications that are not processed within the established time window (Deemed approvals are an extreme application of this principle.);

- Planned staff supplements, maintaining a system for bringing in retired staff or trained consultants to handle overloads and maintain processing targets;

- Project conferences, wherein the applicant is brought together with staff from all relevant agencies as soon as possible to identify as many requirements as possible upfront, to work through conflicts among various approving authorities, and reduce the possibility of "late hits."

2.9 Planning Improvements

A number of observers have argued that one of the victims of California's flawed system for funding local governments has been community planning. In the absence of sufficient general-fund monies, many general plans are out of date, specific and neighborhood plans are not as plentiful and as robust as they should be, and developer-financed CEQA and individual project reviews are used as a substitute for planning foresight. This has contributed to uncertainty for developers and communities alike and has made infill and community change more difficult than they need be.

To begin remedying this situation, proposals are emerging for state funding of a hierarchy of regional, local and neighborhood plans. One of principal proponents of reinvigorated planning has been the Governor of California, but there are equally committed advocates from across the political spectrum in the State Legislature. Outside the halls of government, many environmental and development groups are also getting on the planning bandwagon.

General and specific plans, ideally consistent with a regional development strategy, are seen as a way of “front-loading” the CEQA process, providing a broader context for assessing environmental impact and preventing perverse environmental consequences resulting from the current CEQA emphasis on individual projects. Some observers have noted a particularly pernicious, but presumably unintended, consequence of the present plan-ignorant CEQA process. This is the over-consumption of virgin land and the facilitation of sprawl that occurs because municipalities allegedly mitigate impact by reducing density. This is argued to force unfulfilled demand farther out into the hinterland, where it eats up farmland and open space and contributes to more automobile commuting.

Aside from its potential to intelligently manage the CEQA process, enhanced local planning is capable of providing a number of other benefits, both to the existing community and to agents of change, including developers and investors.

The preparation of plans provides a means for communities to rationally consider the cumulative impacts of development outside of the threatening context of a pressing current proposal, and it allows the design of more systemic mitigations. The difficulty, of course, is in getting the public to pay serious attention to abstract planning exercises done in advance of real projects. While there are effective techniques for achieving high public engagement in planning programs, there will always be individuals for whom development potential is an unknown until a sign goes up on the site next door. At that point, there could be no more grievous assault on their quality of life. These individuals will continue to resist planned change with the same vehemence with which they oppose *ad hoc* projects. However, planning should increase the probability that individual impacts will be effectively mitigated while simultaneously protecting the regional environment. Planning will also provide the broader community with coherent arguments to counter more parochial concerns.

Better plans should benefit the development industry by providing clearer statements of public policy and a more certain context in which to evaluate and design potential investments. By explicitly coordinating public infrastructure with prospective private development and by facilitating mutually supportive uses, well-structured plans should enhance marketability, add value and protect investment.

Planning implementation tools, specifically zoning, can also be improved to encourage smart growth. AB 1268 (Wiggins), passed during the 2003-2004 sitting of the Legislature, permits form-based zoning. This type of zoning substitutes form and design regulations for the traditional separation of uses and, therefore, facilitates mixed-use development, more complete communities, and better quality development. Unlike discretionary zoning ordinances and planned unit development (PUD) zoning, the regulations incorporated in form-based codes are not negotiated with developers, but are prescribed in advance. This provides greater certainty for both developers and affected communities.

2.10 Attractive Communities

This final incentive, while obvious, still requires emphasis as it may be among the most powerful. Developers are encouraged to build in certain areas by the same factors which cause their customers to purchase and rent in those areas. Housing consumers and developers serving those consumers are attracted to communities that provide first-rate public amenities and services. Everything else equal, communities that are clean and well-maintained, that are perceived to be safe, that have attractive and usable open spaces and recreational facilities, that have good schools, and that pay attention to the quality of their public realm will be more attractive to development than communities that are lacking in basic livability qualities. Money spent on high-quality public infrastructure and services is an investment in the future of the community, contributing to continued private reinvestment and renewal.

3. Conclusion

A number of incentives may encourage developers and investors to pursue infill development and other forms of smart growth in existing communities. While some incentives require financial resources and many require cleverness and intelligence to put in place, the common denominator and the principal driving force is a civic attitude that welcomes growth and development. If there is a community will to accommodate growth, then appropriate incentives will likely follow. If that will is not there, then the provision of financial and technical resources, no matter how generous and clever, will most likely be ineffective.